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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

October 15, 1993

William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: *CC Docket No. 93-240 - Accounting for Judgements and Other Costs Associated with Litigation*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Sherry Herauf/WFA

Enclosures

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Accounting for Judgments and Other Costs Associated with Litigation	)	CC Docket No. 93-240
	)	
	)	

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: October 15, 1993

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SUMMARY

By promulgating the proposed accounting rules for antitrust litigation costs, the Commission will establish presumptions about the ratemaking treatment of those costs. Because a presumption of disallowance is very difficult to overcome, any presumption must be well founded and carefully tailored to prevent over-inclusion.

The Commission's presumption that adverse antitrust judgments should be excluded from ratemaking can be justified under the traditional ratemaking standards of necessity and reasonableness. The Litton Accounting Appeal and Litigation Costs Decision can be read to establish that necessity (or ratepayer benefit) is the basis for including litigation costs in ratemaking. To the extent that adverse antitrust judgments do not benefit ratepayers, such judgments are not "necessary" and, therefore, arguably should be presumptively excluded from the ratebase. However, that same logic cannot be applied to pre-judgment settlement amounts, in cases where there has been no finding of an antitrust violation. Pre-judgment settlement amounts should be treated as ordinary business expenses, subject to challenge under the traditional ratemaking standards of necessity and reasonableness. However, if the Commission adopts its proposal to permit recovery only of the nuisance value of pre-judgment settlements, the definition of nuisance value must be expanded beyond "the amount that would have been expended in future litigation" to other legitimate factors ordinarily taken into account in the decision to settle.

The Commission's proposal to treat post-judgement settlement awards as presumptively below-the-line should be rejected because it creates disincentives to settle. Settlement has long been favored to foster judicial economy and to enhance certainty in business decision making. As a minimum, a carrier should be permitted to recover the costs avoided by not continuing to litigate through appeals.

The costs of defense should be accounted for as normal ordinary costs of doing business. Ratepayers benefit from carriers' vigorous defense of frivolous or legally questionable litigation and, therefore, under traditional rate-making concepts investors should not be required to bear the entire risk of litigation costs. Moreover, shifting the expense of litigation to investors will increase investors' perception of risk and require increased return on equity, costs which would be passed on to ratepayers. Finally, the proposal to account for defense costs in a deferral account is contrary to generally accepted accounting principles and to the Commission's previous policies.

The Pacific Companies support the proposal to treat state antitrust litigation similarly to federal antitrust litigation, if state antitrust laws are limited to those statutes which mirror federal antitrust statutes. However, the presumption that supports the treatment of adverse antitrust judgments cannot be automatically extended to non-antitrust statutes. The special relationship between the Commission and antitrust enforcement does not exist with non-antitrust statutes.

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COMMENTS OF PACIFIC BELL AND NEVADA BELL

Pacific Bell and Nevada Bell ("Pacific Companies") respectfully submit their comments to the Commission's Notice of Proposed Rulemaking ("NPRM") and Order, released September 9, 1993, in the above-captioned matter.

I. Introduction

This rulemaking renews the Commission's effort to establish accounting rules and ratemaking policies applicable to litigation costs incurred by carriers in lawsuits involving alleged violations of federal antitrust statutes, state antitrust statutes, and other federal statutes.[1] The Commission's proposed rules would determine whether litigation costs are to be recorded in operating accounts or in nonoperating accounts on a carrier's regulated books of account. For ratemaking purposes,

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[1] Accounting for Judgments and Other Costs Associated with Litigation, CC Dkt. No. 93-240. Notice of Proposed Rulemaking and Order, FCC 93-424, released September 9, 1993.

expenses which are recorded in nonoperating accounts are presumptively excluded from a carrier's revenue requirements for ratemaking purposes (or "below-the-line"). On the other hand, expenses which are recorded in operating accounts are presumptively included in a carrier's revenue requirements for ratemaking purposes (or "above-the-line"). The Commission's rules propose that adverse antitrust judgments, settlements and the costs of defense should be accounted for in nonoperating accounts which are presumptively excluded from ratemaking.[2] The NPRM also proposes to apply these rules to the costs of state antitrust litigation and to non-antitrust federal statutory litigation.

The challenge posed by this rulemaking is to develop rules that will balance ratepayers' and carriers' interests without also creating an administratively cumbersome and costly system. The proposed rules must recognize the reality of antitrust litigation -- the complexity of issues, length of proceedings and the fact that antitrust claims, while often made, are not always meritorious.[3]

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[2] The nuisance value (the proposed definition of which is the saved costs of litigation) of pre-judgment settlements and associated cost of defense would be included or treated above-the-line for ratemaking.

[3] It is unrealistic to expect that the incentives provided by the treatment of litigation costs can be easily parsed. Legal strategy, as well as both plaintiff's and defendant's incentives to continue or settle litigation, depends on the specific circumstances of each case.

The Commission can best accomplish this task by establishing rules that recognize settlements and the cost of defense as presumptively above-the-line but challengeable by the traditional tests of necessity (i.e., ratepayer benefit) and reasonableness.

The following are the principal specific comments of the Pacific Companies to the Commission's proposed accounting rules and ratemaking policies applicable to litigation costs.

II. Costs which are necessary and reasonable should be included for ratemaking.

The Commission invites comment on the extent to which the decision in the Litton Accounting appeal[4] should influence its future treatment of litigation costs.[5] The Pacific Companies support the Litton court's statement of the proper and traditional standard for including costs in ratemaking: "[T]the pervasive element in ratemaking is reasonableness, which demands inquiry beyond the bare fact of antitrust violation."[6] That standard, the reasonableness of a particular expenditure, is well established.[7] The Commission itself has repeatedly

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[4] Mountain States Tel. and Tel. Co. et al. v. FCC et al., 939 F.2d 1021 (D.C. Cir. 1991) ("Litton Accounting Appeal").

[5] NPRM, para. 30.

[6] Litton Accounting Appeal, at 1031.

[7] Southwestern Bell Tel. Co., v. Public Service Comm'n., 262 U.S. 276, 288-89 (1922); West Ohio Gas Co. v. Public Util. Comm'n., 294 U.S. 63, 74 (1934).

articulated the standard in previous proceedings.[8] The Litigation Costs Decision agreed with the Commission that it was reasonable to presume that activity that gives rise to an antitrust judgment (not just an allegation) is unnecessary.[9] Whether the standard is articulated as "ratepayer benefit"[10] or as "reasonably incurred in the ordinary course of business," necessity and reasonableness continue to be the touchstones with which the Commission's ratemaking rules must comply.

III. Adverse antitrust judgments can be recorded in nonoperating accounts.

The Commission proposes to amend Section 32.7370 of its Rules to require that carriers record adverse antitrust judgments in Account 7370, Special Charges, which is a nonoperating account.[11]

The Pacific Companies concur with this aspect of the proposed new rules.

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8 Policy to be Followed in the Allowance of Litigation Expenses of Common Carriers in Ratemaking Proceedings, 92 F.C.C.2d 140, 147 (1982).

9 Mountain States Tel. and Tel. Co. et al., v. FCC et al., 939 F.2d 1035, 1043. (D.C. Cir. 1991) ("Litigation Costs Decision").

10 Id.

11 NPRM, paras. 9-10.

IV. Pre-judgment settlements should be recorded above-the-line.

The Commission proposes to require that carriers record both pre-judgment and post-judgment antitrust settlements in Account 7370 and to amend the language in that account to include settlements.[12] With respect to pre-judgment antitrust settlements, the Commission requested comments on whether it should adopt a policy that allows a carrier to record the "nuisance value" of pre-judgment antitrust settlement in an operating or above-the-line account.[13]

The Pacific Companies object to the aspect of the proposed rules that would require pre-judgment antitrust settlements to be presumptively treated as below-the-line.

The entire amount of pre-judgment antitrust settlements should be included for ratemaking. The presumption by the Litigation Costs Decision that activities which resulted in an adverse antitrust judgment were not necessary or reasonable for ratemaking purposes does not apply until after the judgment has been rendered -- i.e., until after a court has determined that an antitrust violation in fact occurred. But by suggesting that all pre-judgment antitrust settlements should be presumptively recorded in nonoperating accounts the Commission is proposing that the same presumption should apply to a pre-judgment antitrust settlement when there has been no judicial finding of

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12 NPRM, para. 11.

13 NPRM, paras. 12-15.

an antitrust violation. Neither the Litton Accounting Appeal nor the Litigation Costs Decision will support a rule that flows from this unreasonable presumption.

It would be arbitrary and capricious for the Commission to conclude that settlement never benefits the ratepayer in light of clear public policy favoring such settlements. Without a fact-based presumption that ratepayers do not benefit from antitrust settlements, the presumption that follows from nonoperating accounting of such settlements is unsupportable.

Moreover, the Commission has not shown why a pre-judgment settlement in an antitrust action should be distinguished from settlement in any other kind of action.

Applying the presumption to a pre-judgment antitrust settlement would equate such a settlement with an admission of liability and relegates ratemaking decisions to whether the plaintiff pleads antitrust or other causes of action in its complaint.

The implicit presumption of liability (or belief that a carrier would enter into a pre-judgment settlement only to avoid the certainty of an adverse antitrust judgment) is inappropriate. Not only is a settlement not an admission of guilt but the Supreme Court has clearly favored settlement of disputes.[14]

> "'Compromises of disputed claims are favored by the courts; and, presumptively, the parties

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[14] West v. Smith, 101 U.S. 263 (1879); Shipley v. Pittsburgh & L.E.R. Co., 83 F. Supp. 722 (W.D.Pa. 1949).

> to the compromise in question possessed the right to thus adjust their differences.' Williams v. First National Bank, 216 U.S. 582, 595, 30 S.Ct. 441, 445, 54 L.Ed.2d 625 (1910)."

The proposed treatment of pre-judgment settlement will discourage settlement and undermine the long-standing legal and public policy in favor of settlement.[15] Settlement is beneficial because it conserves judicial resources and reduces business uncertainty. Settlement is economically efficient and benefits ratepayers because it permits the parties to resolve their differences at reduced costs and frees business to spend their resources on providing services.

Settlement is also a legitimate and reasonable business response to litigation. Being able to include settlement costs in operating accounts (with the presumption of above-the-line treatment) will certainly not be the primary consideration in management's decision to settle or to defend a case. That choice will be based on sound business judgment regarding customer perceptions, goodwill, the risk of disclosing proprietary information, disruption to the ongoing business, economical use of resources, the importance of the legal principles at stake as well as the company's belief in its own guilt or innocence. Ultimately the decision to settle will rest on an evaluation of the costs to the company to continue to litigate and the costs to settle, regardless of whether the ultimate outcome is favorable

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[15] 15A Am. Jur. 2d Compromise and Settlement, §5 (1976).

or adverse. Such business decisions are an ordinary part of how all companies do business and the resulting settlements should be treated as an ordinary cost of doing business.

For carriers which are under price cap regulation, the question of whether litigation costs are recorded in operating or nonoperating accounts will usually not be the decisive factor in the decision whether to settle or not settle a lawsuit. For price cap local exchange carriers ("LECs") which are subject to a sharing mechanism, it is true that the operating/nonoperating account distinction is a factor in determining whether the price cap LEC is within the sharing zone. However, only very significant litigation costs will have an effect on whether a price cap LEC is within the sharing zone, and the structure of the sharing mechanism limits the effect of such costs initially to only 50 cents on the dollar.

If the Commission adopts the proposed requirement that an antitrust settlement must be recorded in a nonoperating account, guidance will be needed on some of the issues that will arise in dealing with multiple claims. For example, how should a carrier treat a settlement if the complaint alleges a variety of antitrust claims, federal statutory claims and state statutory and common law claims? How should a settlement with both monetary and nonmonetary aspects of a multiple count case be treated?

V. The definition of nuisance value should be broadened.

The Commission proposes to permit some amount of a pre-judgment settlement, the nuisance value, to be recorded in an operating account.[16] The Commission is correct in recognizing that a nuisance value offset is appropriate. The nuisance value should be defined, however, to include more than merely the costs of litigation avoided by settlement.[17] The definition should be expanded to recognize the fact that a settlement avoids the hazards of litigation, conserves scare employee resources (e.g., the time of both legal and non-legal employees to continue to litigate), and saved lost opportunity and other hidden costs. Permitting recovery of additional types of cost and expense-avoidance acknowledges the realistic components of the cost-benefit equation, inherent in any settlement decision.

VI. Post-judgment settlements should also be recorded in operating accounts.

The Commission also proposes to require that carriers record all post-judgment antitrust settlements in a nonoperating account.[18] For many of the same reasons that the Pacific

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[16] NPRM, paras. 4 and 12-15.

[17] The Commission recognized that saved litigation costs included costs saved from collateral proceedings and saved in-house counsel replacement costs. Alascom, Inc: Request for Ratemaking Recognition of an Antitrust Settlement, Memorandum Opinion and Order, FCC 91-179, released June 24, 1991.

[18] NPRM, para. 11.

Companies object to the proposed requirement to record pre-judgment antitrust settlements (except for a nuisance value component) in a nonoperating account, we also object to the proposed requirement that post-judgment settlements be recorded in a nonoperating account.

Moreover, the Commission's proposed rule provides incentives for a carrier to appeal from an adverse antitrust judgment when there would otherwise be sound business reasons to settle. This is inconsistent with the policy of encouraging settlements discussed above.

On the other hand, because the outcome of a complex antitrust case is frequently different at the appellate level than at the trial court level, carriers may have valid legal reasons to appeal adverse antitrust judgments, and plaintiffs which were successful at trial may recognize that it may be in their financial interests to enter into a post-judgment settlement. For example, the outcome of MCI Communications Corp. v. AT&T, 708 F.2d 1081, cert. denied 464 U.S. 891 (1983), was distinctly different after the defendants' appeal. At the original trial, the jury returned a verdict in favor of the plaintiffs for $600 million (before trebling). The defendants appealed that adverse judgment, and the Seventh Circuit reversed the damage award and remanded the case for a re-trial on the damages issue. At the re-trial, the jury awarded the plaintiffs only about $38 million (before trebling), and the case was thereafter settled on a basis quite favorable to the defendants. In that situation, it would appear to be unreasonable not to

record either the post-judgment settlement or the litigation expenses in an operating account.

VII. The nuisance value offset should also apply to post-judgment settlements.

The Commission requests comment on whether a nuisance value component of post-judgment settlements should be presumptively recorded in an operating account.[19] For the reasons stated above, the Pacific Companies urge that if the Commission does not adopt rules which provide for the recording of the entire amount of post-judgment settlements in operating accounts, as a minimum, the rules should provide that a carrier could presumptively record the nuisance value of the case in an operating account and the remainder of the post-judgment settlement in an nonoperating account.

VIII. The costs of defense should be accounted for as ordinary expense of doing business.

The Commission proposes to require that antitrust litigation expenses be accrued in a balance sheet deferral account until the case is resolved. On entry of an adverse nonappealable final judgment or a post-judgment settlement, the expenses would be charged to a nonoperating account. If the case

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[19] NPRM, para. 12.

is resolved in favor of the carrier, the expenses would be amortized in an operating account over a reasonable period.[20]

The Pacific Companies do not support the Commission's proposal that the cost of defense should follow the ratemaking treatment of adverse judgments or post-judgment settlement amounts. The cost of defense is an ordinary business expense and should be evaluated for ratemaking by the traditional tests of necessity and reasonableness. The Litton Accounting Appeal recognized that the basis for judging whether the cost of defense should be included or excluded from ratemaking was the need for and the reasonableness of the costs of legal defense, not the need for or the reasonableness of the activity which resulted in the filing of the case.[21] Thus, cost of defense should not depend on the outcome of the lawsuit but rather should be recorded in operating accounts and subject to challenge as unnecessary or unreasonable just as any other expense may be challenged.

The reality is that large companies with deep pockets are targets of litigation and antitrust litigation is particularly often used to gain a competitive advantage. A carrier has no control over whether or what legal actions are brought against it or what causes of action are pled in such lawsuits. These days, virtually any commercial dispute may include antitrust claims. As the Commission itself recognized,

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20 NPRM, paras. 16-19.

21 Litton Accounting Appeal, at 1031-1032.

costs of defense are an expected and necessary expense of doing business in today's litigious society.[22]

A vigorous defense of all claims against the carrier is in the ratepayers' interest, as well as a company's obligation. If a carrier failed to defend itself against all litigation claims, it could become known as an easy target for big settlements. Such a reputation could leave a carrier financially unable to continue to provide service to its ratepayers. In addition, shifting the cost of defense to investors can ultimately disserve ratepayers. Investors who must bear the entire risk of antitrust litigation cost will require greater reward (i.e., increased return on equity) for the perception of greater risk. The resulting higher cost of capital would be passed on to ratepayers.

If the Commission adopts the proposed below-the-line treatment of the costs of defense, guidance will be needed on some of the issues that will arise in dealing with multiple claims. For example, how should a carrier treat defense costs if the complaint alleges a variety of antitrust claims, federal statutory claims and state statutory and common law claims?

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[22] See Accounting Instructions for the Judgment and Other Costs Associated with the Litton Systems Antitrust Lawsuit, 98 FCC 2d 982, 984 (1984).

IX. Deferral accounting for the costs of defense is inconsistent with Generally Accepted Accounting Principles ("GAAP").

The proposed rule directs carriers to record costs of defense in a balance sheet deferral account pending final decision. This alternative departs from the Commission's well established objective to bring accounting practices of regulated carriers into line with those of nonregulated businesses.[23] Nonregulated enterprises must account for litigation defense costs as ordinary business expense in the period in which costs are incurred.[24]

Deferring litigation expenses is also improper according to Statement of Financial Accounting Standards No. 71 which provides for the deferral of expenses only if it is probable that the deferred costs will in fact be recovered in the future. The Commission's proposed rule does not condition deferral on the probability of recovery. Deferral accounting would be required regardless of the probability of recovering the expense from ratepayers.

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[23] Revision of the Uniform System of Accounts for Telephone Companies to Accommodate Generally Accepted Accounting Principles (Parts 31, 33, 42, and 43 of the FCC's Rules), CC Docket No. 84-469, Notice of Proposed Rulemaking, FCC 84-200, released May 18, 1984.

[24] Accounting Principles Board Opinion 30.

The Commission's recognition of the problems associated with the deferral approach led it to reject this approach in an earlier proceeding:[25]

> "A major problem with the deferral approach is that the deferred costs may well remain in the account for a lengthy period of time given the long time necessary to resolve many antitrust proceedings. The existence of such deferred costs could create uncertainty in the financial community as to the profitability of the carrier and its ability to recover costs which may well later be shown to have been prudently incurred."

The Commission was correct when it rejected deferral accounting in the Litigation Order. The Commission should also reject the proposal now.

X. The rules should be extended only to state antitrust statutes which mirror the Sherman Act antitrust statute.

The Commission proposes that its litigation costs rules would apply to state antitrust lawsuits as well as to federal antitrust lawsuits.[26]

The Pacific Companies agree with the Commission that state antitrust actions can be treated in the same manner as

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25 Notice of Proposed Rulemaking to amend Part 31 Uniform System of Accounts for Class A and Class B Telephone Carriers to account for judgments and other costs associated with antitrust lawsuits, and conforming amendments to the Annual Report Form M, CC Dkt No. 86-64, Report and Order, 2 FCC Rcd 3241 (1987) ("Litigation Cost Order").

26 NPRM, para. 21.

federal antitrust litigation costs. The presumption that the activity underlying an adverse antitrust judgment does not benefit ratepayers applies whether the antitrust claim is based on a state or federal statute. However, the Commission must clearly define what is meant by state "antitrust" actions. Given the diversity among state antitrust statues, the rules must be limited to those state antitrust statutes which mirror the Sherman Act antitrust statute. Otherwise, the presumption underlying the treatment of federal antitrust awards and post-judgment settlements may be improperly applied to business torts which may be included in state unfair competition statutes. And, as discussed below, the Commission has stated that it does not intend to extend the proposed treatment of antitrust litigation costs to common law actions such as business torts.

XI. The rules should not be extended to litigation of other federal statutory violations.

The Commission proposes to apply its proposed rules for antitrust litigation to lawsuits involving other federal statutes.[27]

The Commission's rationale in declining to extend the proposed accounting and ratemaking rules for antitrust actions to expenses incurred in defense of common law actions also applies to alleged violations of federal statutes other than the

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[27] NPRM, para. 22.

antitrust laws. The Commission explains that most common law actions against carriers arise out of events that occur in the normal course of providing service to ratepayers, and ratepayers benefit from the provision of service.[28] The Commission's rationale is correct. However, the line the Commission draws for common law actions should also be the basis for limiting the proposed rules only to antitrust litigation.

Further, unlike most other federal law, antitrust law is of special relevance to the Commission. The Commission's interest in promoting competition and regulating the competitive process places carriers in a special position vis-a-vis antitrust law. Congress recognized that by granting the Commission the authority to enforce carriers' compliance with the Clayton Act.[29] The same is not true for other federal statutes. The Commission has no special charge regarding, for example, environmental protection; nor are carriers in a unique position vis-a-vis other federal statutes.

XII. The Commission should adopt a list of other federal statutes.

The Commission asks for comments on whether the it should review other federal statute lawsuits on a case-by-case basis or adopt a list of non-antitrust federal statutes for which

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28 NPRM, at para. 22.

29 Litigation Cost Order, at 3244.

it can be reasonably assumed that the carrier's actions in violation of the statute did not benefit ratepayers.[30]

As noted above, the Pacific Companies urge the Commission not to extend its proposed rules to non-antitrust federal statutory violations. However, if the Commission decides to do so, the Commission should identify those specific statutes for which the presumption that ratepayers would not benefit would apply. To do otherwise would be to replicate the very problem that led to the Litigation Costs Decision vacating the previous rules.[31] In other words, the Commission should demonstrate why it is reasonable to presume that ratepayers do not benefit from events that occur in the normal course of providing service but that may trigger allegations of violations. It will be difficult to do so on a blanket basis. Moreover, as the Commission recognized, the variety of federal statutes is too diverse to permit a nondiscriminating determination.

XIII. Conclusion

For the reasons above, the Pacific Companies urge the Commission to modify the rule changes proposed by the Notice of Proposed Rulemaking. The Commission should revise the proposed rules to incorporate the recommendations made herein which uphold

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30 NPRM, paras. 24-25.

31 Litigation Costs Decision, at 1042.

the traditional standards of necessity and reasonableness as the basis for the treatment of costs for ratemaking.

Respectfully submitted,

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